DOW THEORY LETTERS INC.

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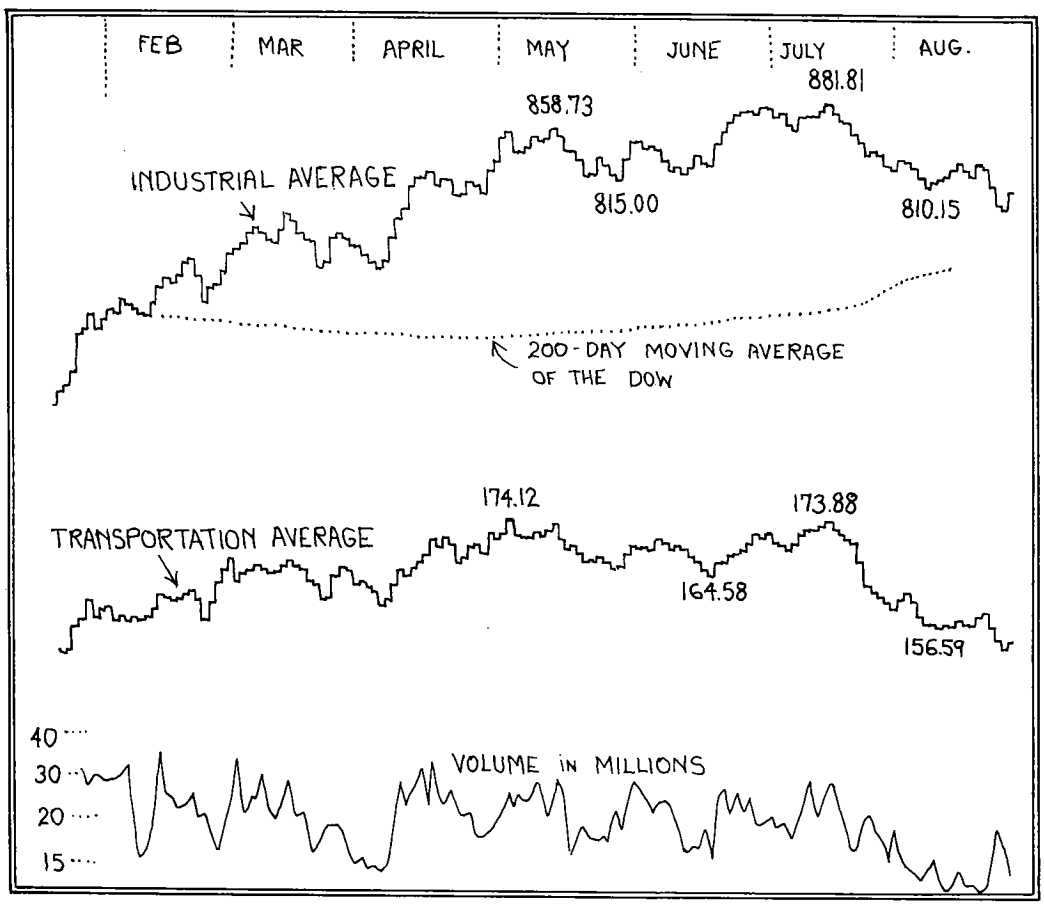
START: Many, many years ago I entertained the idea that if enough laws were passed and enough money was spent, the entire world could slowly but relentlessly be moved towards the heavenly state. I guess I've changed my mind. And it's been a rather fundamental change, at that.

After careful study and many years of questioning and debate, I've come to the conclusion that the only hope for the human race is for each man to take responsibility for himself. And I mean full responsibility: responsibility for his morality, his livelihood, his actions, his whole life. Unfortunately, I feel that the world is moving in quite the opposite direction. Why is this? The answer, I believe, is because power lies in the opposite direction.

If you won't make a living, if you won't control your desire to steal or shoot your neighbor, if you won't control your urge to over-eat or over-spend or over-smoke, then a new state or government agency can be set up to "help you" with your life. And that new agency creates bureaucrats and a need for more funds and a whole new power structure. And that power structure is self-perpetuating.

So what does the average citizen do? He complains and over-indulges and plays the baby and moans about his taxes and continues to give his power and responsibility away. It all goes on and on until the state finally sinks under a mass of debt, inefficiency, mismanagement and just plain thievery.

I was just going over some figures on the British situation. The British story would be comical if it wasn't so disastrous. For instance, Britain's nationalized steel industry is losing money at the rate of $11 million a week or a $550 million loss this year. The nationalized British gas industry lost $97 million in the fiscal year which just ended. The nationalized railroads lost $350 million last year (with two rate increases to help them). The nationalized electric power industry lost $565 million last year. The British post office lost $675 million last year and is doing no better this year. All in all, nationalized British industry has lost $1.7 billion so far in 1975.



"Is the US going the same way?" I ask myself. Does US stand for "unrestrained spending"? The latest annualized projection for the current US deficit is $104 billion. No comment needed there. San Francisco is staggering through its first police and firemen's strike (I'm leaving for SF today). Projections for LA suggest that it could, in time, follow NYC into insolvency. Across the face of the nation citizens are demanding that the cities and states take care of them. People tell me that it's easier to collect unemployment than to work - and more profitable.

In San Diego the beaches have been well-populated all summer — during the weekdays and around the clock. I'm all for a lot of leisure time, but I am beginning to wonder who's doing the work these days. And the deficits and the borrowing continue to grow— even while the latest Consumer Price Index figures show inflation to be at a rate of 14.4%.

"OK, OK," you answer, but to get back to responsibility, what do you mean by taking responsibility for yourself?" Well first it involves giving up the illusion (and this is the world's most widespread illusion) that we are all children and that we still have daddies and mommies. The fact (the dreaded fact) is that we are not children, and we don't have parents any more. The only "father" we have is the one up there in heaven watching over us, and the only "mother" we have is the girl or woman who is willing to baby us and play the part.

But our real job on this earth is (1) to find ourselves, (2) to get in harmony with life, and (3) to live accordingly. That's one huge job, and it entails cutting through all the garbage we tell ourselves, no matter how much pain is involved in that process.

All right, now let's turn to the stock market. One of the fascinating things about the market is that it provides us with instant reality. Here's how it works. If you mix your wishes or your preconceived notions with your stock dealings, then "presto," you have an immediate and usually growing loss. The stock market swallows up rumors, bunk, inside information, greed, excitement the way the ocean swallows up sand castles. And out of that unreality comes losses. They'll come every time.

If you deal in the stock market you'll ultimately learn what stocks are all about, you'll get in reality about your investments, or you'll lose your shirt.

I term this "Wall Street's relentless truth," and we all face it sooner or later. The unfortunate result of this truth is that a large percentage of would-be investors end up licking their wounds and leaving the world of stocks (many forever). A small percentage of investors take the trouble, undergo the painful lessons, and learn how to take more money out of the Street than they put in.

Strangely, the same process applies in life. It all starts with humility. A small fraction of the human race possesses the humility to realize that they don't know anything. That is the beginning of wisdom. Then they proceed on the thesis put forth by the great Teacher of two centuries ago, "Ask, and it shall be given you; seek, and you shall find; knock, and it shall be opened unto you." I've never known that process to fail, either in life or in the stock market.

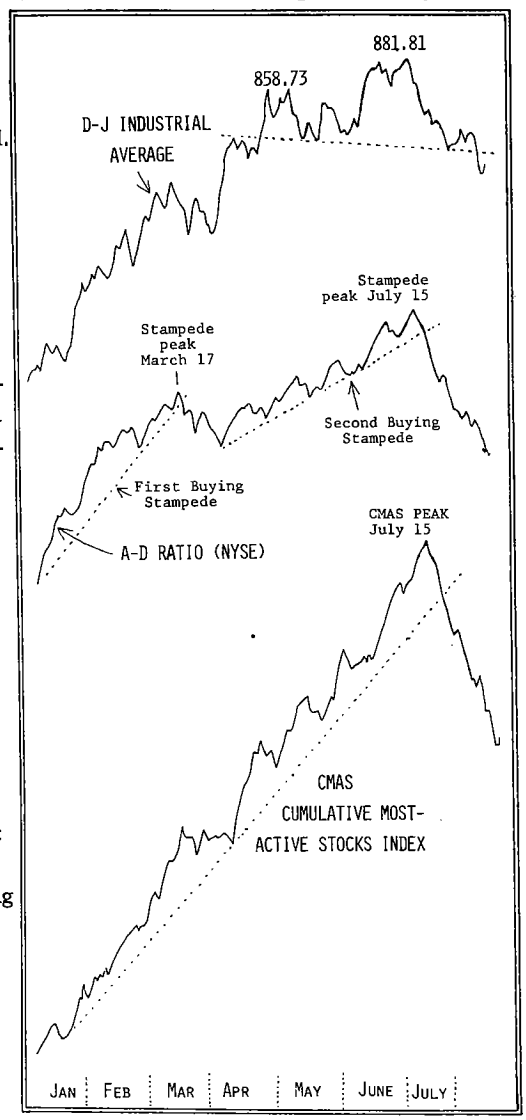
THE MARKET: The 1974-75 advance ended on May 5, the point at which the Averages registered their last confirmed highs (see page 1 chart). The Transports stalled out on May 5 at 174.12, and they gave the lie to all the upside action which followed. In July the Industrials mounted a valiant attack on the upper regions, reaching a closing high of 881.81 on July 14. But July 15 found the Transports still lagging, closing the day at 173.88 (which was still .24 below their May 5 peak).

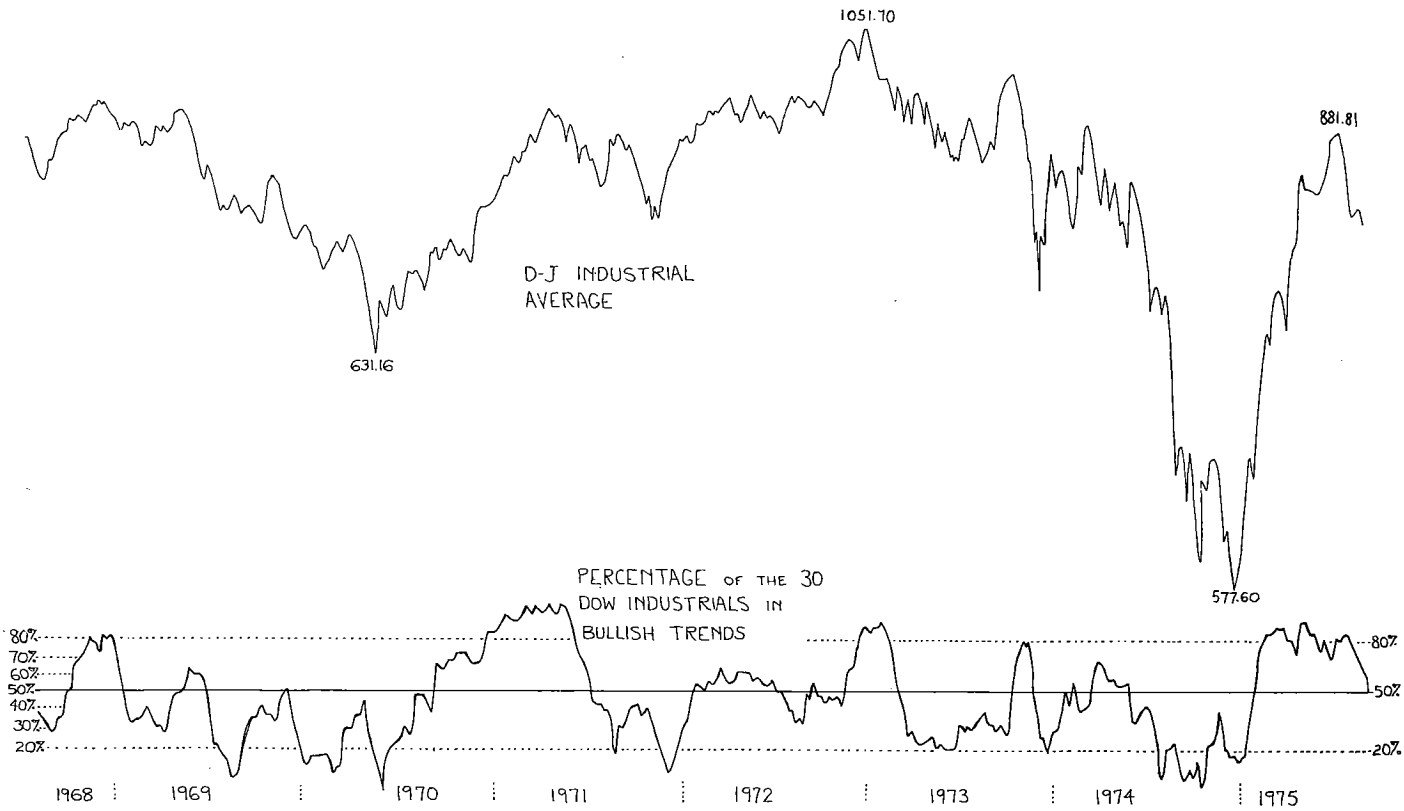
After that dramatic but frustrating Transport non-confirmation came the deluge. The market and the Averages have swooned through the second half of July and most of August. On August 19 the Industrials closed under the 815.00 low of May 29, a level I had warned about in preceding Letters. In so doing, Industrials confirmed the downside action of the Transports, and a full-fledged secondary reaction was signaled. On August 20 Industrials plunged below the 800 level while Transports broke to their lowest ground since January.

The secondary reaction syndrome on Wall Street is strange indeed. It starts with almost everyone denying it can happen at all (and, of course, we now know that this reaction began on May 5). Then, as the secondary gets underway, fear starts building. Invariably, people start calling me to ask "How far can it go?" The answer is that I have no idea how bad it can get and neither does anyone else. My original guess was that this July-top (for the Dow) reaction could end up with big volume and a scare-rupturing of the 700 level. This would give us about a two-thirds correction of the 1974-75 advance. But that's only my guess, and I would not suggest that you make book on it.

Turning to the chart of the advance-decline ratio and the CMAS, note that on August 20 the A-D sliced under its April 7 low, which is ghastly action indeed. It means that the A-D has wiped out all the upside action going back to late-January, including all the gains of the second buying stampede. Thus, I feel that the market has now "taken back" a good deal of its early forecast for an expanding economy during late 1975 and 1976.

On top of the July-August crash in the A-D ration (which involves the majority of stocks on the NYSE), the cumulative most-active stock index (CMAS) has been in





a headlong plunge. Here again, we have an abrupt and really extraordinary reversal of sentiment as the big money rushes out of equities (as seen by the rare "waterfall" pattern in the CMAS). Readers know that I have attached a good deal of importance to the CMAS, the index which was, during the first half of 1975, the strongest single technical indicator. When the CMAS breaks, I wrote, then the market breaks with it. And that is what has happened.

I have written that many or most secondaries are separated by at least one recognizable rally. If you study the formation of the Dow Industrials on the same chart, you will note that I have drawn a "neckline" or support line at the 815 level. The drop from 881.81 to 815-820 touched the support (dashed line), a little rally ensued, and then came the break below 800. Veteran readers will immediately recognize the formation in the Dow as a "head-and-shoulders" top. They will also note that the plunge below 800 (August 20) completed the structure. Whether the little rally of mid-August will serve as the halfway point for this decline I do not know, but I would say that the Dow could fall to the 740 level before halting its slide and rallying. Following a rally, a second decline could easily test the 700 (or below) level.

I cannot get the 1957 reaction pattern out of my head, and if the current decline follows '57, we could see ultimate panic selling on high volume as this whole decline winds to a close. As a rule, the lower the market drops on dull volume, the better the odds that an ultimate selling climax or high-volume panic will materialize. Wall Street hates smugness. The viciousness of a reaction is often directly proportional to the extent of the disbelief in the downside. Very few people today are talking in terms of a Dow under 700. And that bothers me.

PERCENTAGE BULLISH: For the past ten years I have been keeping a chart of the Dow Industrials together with three indexes, one showing the percentage of all NYSE stocks in bullish trends, the second showing the percentage of all NYSE stock groups in the bullish trends, and the last showing the percentage of the 30 Dow Industrial issues in bullish trends.

In studying the relationship of the Dow and these three bullish percentage indexes, I have found that the best indications consistently come from the percentage of the 30 Dow Industrials in bullish trends. This is the leader and the most sensitive of the three indexes. I have pictured the movements of the Dow bullish percentage on the accompanying chart.

Market tops, or at least tops in the Dow, have been associated with those areas in which 80% or more of the Dow Industrials issues are in bullish trends. These tops may be of primary or secondary importance. Conversely, bottoms (primary or secondary) have usually been associated with very oversold conditions in which 10% or fewer of the thirty Dow Industrials have been in bullish trends.

The rationale for this experience with the Dow bullish percentage index is clear enough. At 80% bullish or above, we have a situation wherein the Dow stocks have anticipated a great deal of whatever good news lies ahead.

The 80% bullish reading means that the market is saying that things can't get much better, and that Wall Street has done its job of discounting the best. Conversely, when the Dow stocks drop to 10% or less in bullish trends, the market is saying that the worst has been discounted, and that the market is "on its back and looking up." The "up" constitutes the basis for the rally that always follows a period of collapse in the percentage of Dow stocks in bullish trends.

Referring to the chart on top of page 3, note that we had an 80% bullish reading for the 30 Industrials in late-1968. This corresponded with a December 3 top of 985.21 on the Dow. From the 80% bullish reading, the index plunged to a 6% bullish reading in early 1970. This jibed with the May 26 extreme low of 631.16 on the Dow.

From the 1970 low, the Dow rose to an April 28, 1971 peak of 950.82. Here we see the bullish percentage booming to an extraordinary 96%, at which point the Dow and the market topped out. By late 1971 the Dow was down to 797.97. Simultaneously, the bullish Dow percentage dropped to exactly 10%.

The dramatic rise which followed rocketed the Dow to an all-time peak of 1051.70 on January 3, 1973. The same advance took the Dow bullish percentage to a dangerous 86%. The twin movements presaged the greatest market collapse since the 1930's. The market dropped steadily during 1973 and 1974. By October, 1974, the bullish percentage of the Dow had sunk to 6%. Two months later, on December 6, 1975, the Dow bottomed out at 577.60.

All of which brings us to the present. The rise from the 1974 lows was spectacular for both the Dow and the market. In mid-March the bullish percentage for the Dow rose to an uncomfortable 86%. This meant, again, that the Dow had discounted a great deal of whatever good news lay ahead. That 86% bullish reading also served to turn me rather cautious.

The momentum and power of the 1975 rise pushed the Dow onward to a July 14 peak of 881.81. But note that the latest rise in the Dow failed to take the bullish percentage to a new high above the earlier 86% bullish. In fact, the bullish percentage index has recently traced out a "head-and-shoulders top" pattern, something I have not seen before in this index (and I take this H & S pattern as being rather ominous).

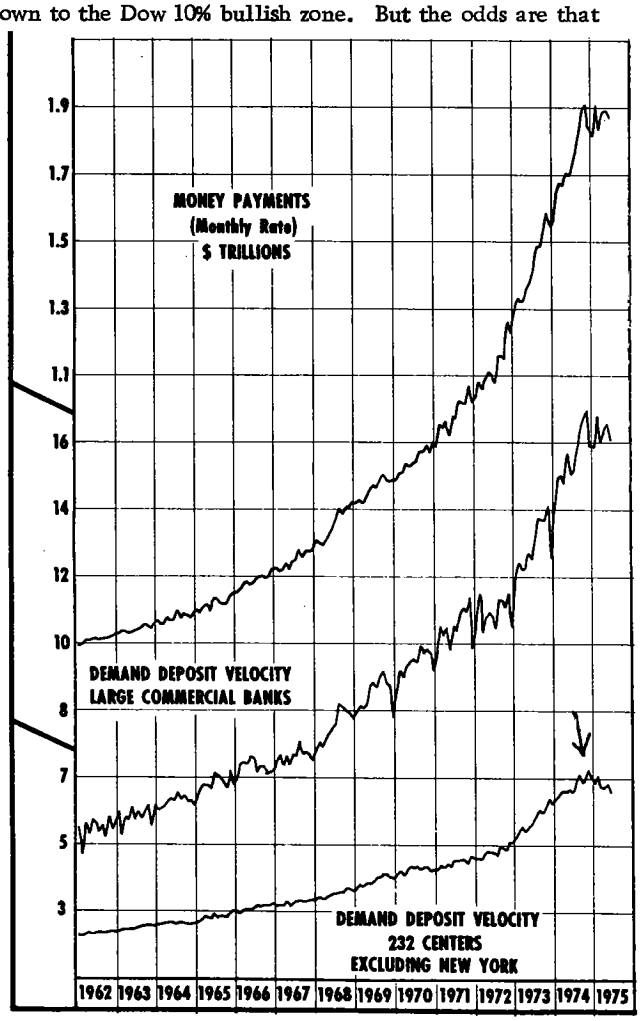
By last week, the bullish percentage of the 30-Dow stocks had dropped back to the 50% level. My guess would be that before this market bottoms out (and aside from the ever-present rallies) the Dow bullish percentage will once again sink to the 10% bullish (or below) area. Such a reading will probably be associated with a market which is in a good deal of disarray. In other words, based on past experience, this market should head generally lower until an oversold condition in the form of a very low reading on the Dow bullish percentage index is seen. Just how long and in which way the Dow will move towards the classic oversold pattern cannot be foreseen at this time. I feel that we could have an extended and rather frustrating trip down to the Dow 10% bullish zone. But the odds are that that is the path we are following.

ECONOMY: Almost every economist, businessman and market analyst is familiar with the various monetary statistics which serve to tell us how much "water is in the troughs." The water, of course, is the money supply and the net reserve position of the member Federal Reserve Banks. What most of the economists don't watch, however, is the desire of the population to drink (or not to drink).

I first learned about the measurement of this kind of desire from Hamilton Bolton, founder of the famous Bank Credit Analyst. Many years ago Bolton talked about the velocity of demand deposit (checking account) turnover at the banks. Put in simple language, this velocity measures how often the bank deposits are rolled over, how much desire and need there is for the money at the banks. Like any other business, the banks can do a lot or a little with a given amount of money depending on the demand. When business is slow the banks might turn over their deposits 50 times a year. When business is white hot, those deposits might turn over 300 times a year.

One service which keeps track of demand deposit turnover is the Drew Odd Lot Studies (1915 NE 45th St., Ft. Lauderdale, FL 33308). I am using Bill Bretz's (the editor) chart of deposit turnover in the large commercial banks and at the 232 centers outside NYC. Since the commercial banks handle most of the financial (stock and bond) transactions, they can provide a distorted view of business and what is happening in the country. Therefore, the bottom line showing the turnover at the 232 centers outside NYC is the one to study.

What we see here is the first definite decline in demand deposit turnover in decades. This contraction is most unusual and most disturbing. It



could be just a temporary phenomenon, or it could be the start of something big. We poor market writers (lacking crystal balls) have no way of knowing. But I do know that a rising money supply doesn't mean a damn thing if demand deposit velocity continues to drop.

Back in the late 1950's Hamilton Bolton used to talk about a coming explosion and ultimate "spike formation" in the deposit turnover index. He also talked about a point of no return, a spiraling up of the turnover rate until finally the deposit turnover, like a roaring engine which is out of control. would tear itself apart and come crashing down to earth. Have we reached and passed that juncture? Has demand deposit turnover passed the point of no return?

The odds are always heavily against a disastrous situation. Market crashes and economic collapses are great rarities. That is why I would say that the odds are against the demand deposit turnover rate having passed the point of no return. But if the deposit turnover rate does continue in its current downward path, we're going to have a very, very difficult situation in the months ahead. We would see inflation collapse, deflation take over, unemployment on a massive scale and another stock market crash.

Meanwhile, I'll continue to watch the turnover rate for bank deposits. If there's real trouble ahead, I feel (intuitively) that it's going to show itself in that area (and I should add, in the area of the stock market itself).

VALUES: In the last report I wrote a bit about values. The study of values constitutes the foundation of true investing. Market studies, technical analysis, timing, these are simply our guides as to when stocks move above or below known values (for instance, at bull market tops or bear market bottoms). But the master investors are the ones who know the true meaning of values.

What has all this to do with today's market? At this point we are moving into one of the most extraordinary eras in the annals of Wall Street. As I explained in the last Letter, many of the listed (on the NYSE) bond funds are now providing yields of up to 10%. Some of the municipal funds (tax free) are yielding 7.8%. The highest-rated Aaa bonds are now yielding an average of 8.9%. Lesser quality bonds are providing yields up to 12% (and much higher if you are willing to take more of a risk). In the face of this, the stock market is having troubles. The trouble is centered around values.

Stocks on average now yield around 4.5%. At this rate (forgetting taxes) it takes 16 years (at annual compounded rates) for you to double your money. "But what about appreciation?" you ask. And I say, appreciation may or may not occur. But I don't know anyone who is willing to guarantee it. The record of professionally managed portfolios over the past 20 years is so bad that most institutions would rather not talk about it. Over the last 10 years many institutions would probably show a net loss. Who is to say that they will do any better over the next 10 years or the next 5?

Then there's the problem of inflation. If inflation averages only 6% a year for the next 10 years and the yield on a stock is 4% and you show no appreciation, then you are going to experience a net loss or purchasing power on your investment. In that case, it's not an investment, it's a headache. And this is one of the reasons why the glamor stocks have been so badly battered. The environment is not as healthy for profits now as it was 10 years ago. The yield on most glamors is very low (often in the 1% to 2% range). Appreciation in equity is anything but guaranteed. So holders of glamor stocks are faced with the possibility of sitting on an equity which is going down in value, which is producing a very low yield, and which is actually showing a further loss due to a high inflation rate.

Against this, we now have a most interesting investment vehicle, the high yielding, high quality bond. This debt insturment is capable (if interest payments are not kept up) of throwing the parent company into bankruptcy. It has power, and therefore superior safety to the common stock of the same company. Moreover, the bond at current fantastic yields can (at worst) provide some real purchasing power. At 9% yield, money (compounded annually) doubles in less than 8 years. At 10%, money doubles in about 7 years.

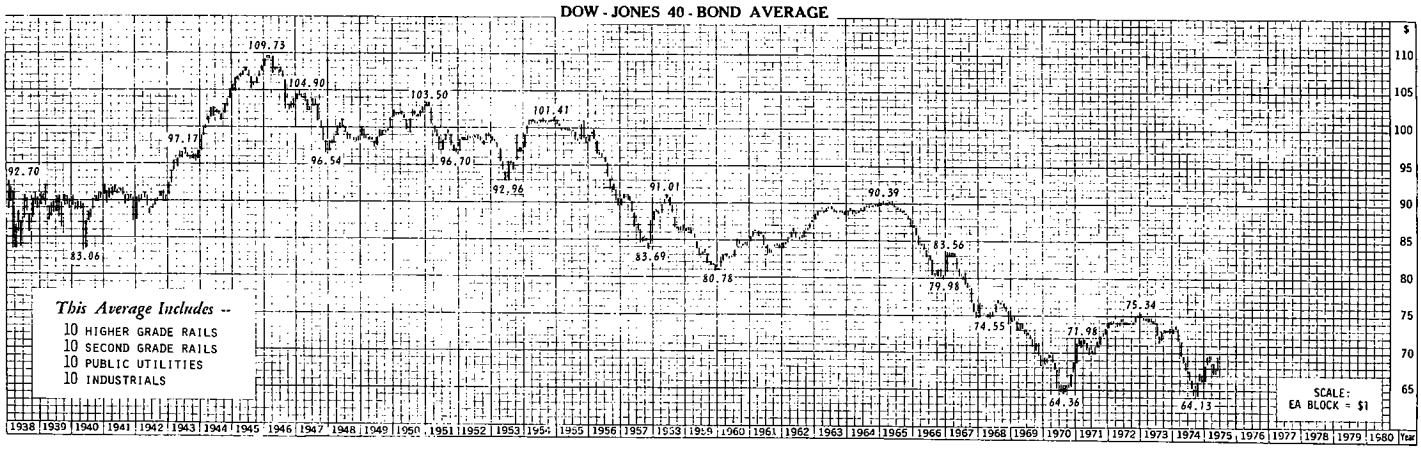
Now let us not kid ourselves. In today's inflation-torn, whipsawing, money-rate sensitive markets, it is no mean feat to double the value of your stock portfolio every seven years. And what is more, the money managers are beginning to realize this. So are the pension fund managers. So they are getting the fear of God in them, they are starting to unload those high-flying, glamorous, 1% yielding equity numbers in favor of Aaa or Aa-rated high-yielding bonds.

"But what about inflation?" yesterday's analyst objects, "bonds won't hold up in the fact of two-digit inflation." And the answer is that two-digit inflation isn't guaranteed at all. But the best answer and the surest is that one-digit stock yields have never held up in the face of two-digit bond yields. And that is why we're seeing trouble now. The investor can currently purchase a long list of good quality bonds, all yielding 10% or more. And that's more that Wall Street can withstand.

My own feeling at this time is that the stock market is now telling Washington and the Fed what they did not want to hear. It's the story I've been warning about all year. "The big business expansion" is not about to happen. The consumer is strapped for cash and saving what he can. The banks are socking cash away, holding back on loans, recovering from their fright over 1974, and trying to get liquid. And business is skeptical about the promised recovery and very cautious about new capital commitments.

The next stage is probably occurring now. The Fed is seeing the picture, and it is moving to make money more available. It would also like to bring interest rates down. Thus, I expect a rally in the bond market over the next few months, or I'll put it another way. If interest rates don't come down, if the bond market can't produce a rally, we are going to see one very sick fall, 1975 (and I'm not sure that we won't see a dull business picture for the rest of '75 even with interest rates heading lower).

As I've said so many times before, each recession bail-out since 1949 has required greater infusions of bank credit. Now, we're at the point where an expansion of the money supply brings on more in the way of inflation than it does a pick-up in business. The money supply medicine still produces the bad taste, but it isn't helping the patient any longer.

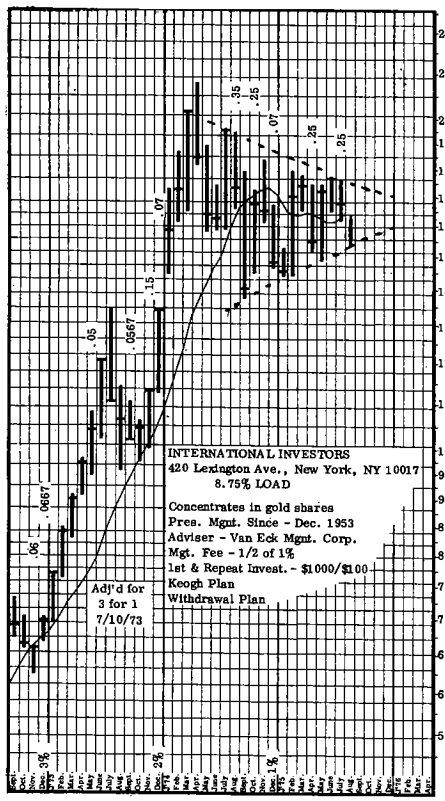


GOLD: In the latest issue of GOLD (PO Box 814, Lausanne 1002 Switzerland) Harry Schultz and Fred Macaskill take the writer to task to what they feel is my incorrect gold stance. "Either he or we are making a grave error," they write. They note that just as they were calling a new bull market in gold, I insisted that gold was in a primary bear market. That statement, they said, made them "particularly sad."

I guess I read just about as much on gold as anyone else. I spent last weekend with James Dines up in Sausalito, and that alone should encrust me with a 14-carat gold plate. However, I am damn fool enough to think that my own intuition and my own charts are as good as the next guys', and from what I see, I'm still not convinced that gold is ready to rocket skyward.

In fact, I would say that if the bear market in gold is over and if this is indeed the bottom, then it's most extraordinary. I've never seen a major bottom so well advertised, and I've never seen a bottom wherein investors had so many golden opportunities to get in on the ground floor. But then, maybe all these years of watching markets have made me a hopeless cynic.

I'm including a most interesting chart of International Investors, the leading open-end fund, a fund which is almost entirely invested in gold shares. I use this fund as a gold index. Last week Int. Inv. hit a bid price of 15.33. That price takes the fund down to the lower trendline of the triangle which I have drawn. The fund is quoted daily in the papers. If Int. Inv. drops below a bid price of 15 in the period ahead, then I feel that Dr. Schultz and Mr. Macaskill will see more of what I'm talking about regarding whether gold is in a bear market or not. Until then, I'm neutral to bearish on gold, but I'll always bow to the superior forecasting abilities of the market (chart of Int. Inv. courtesy of Growth Fund Guide, PO Box 2109, San Clemente, CA 92672).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Pres. Mgmt. Since - Dec. 1953
Adviser - Van Eck Mgmt. Corp.
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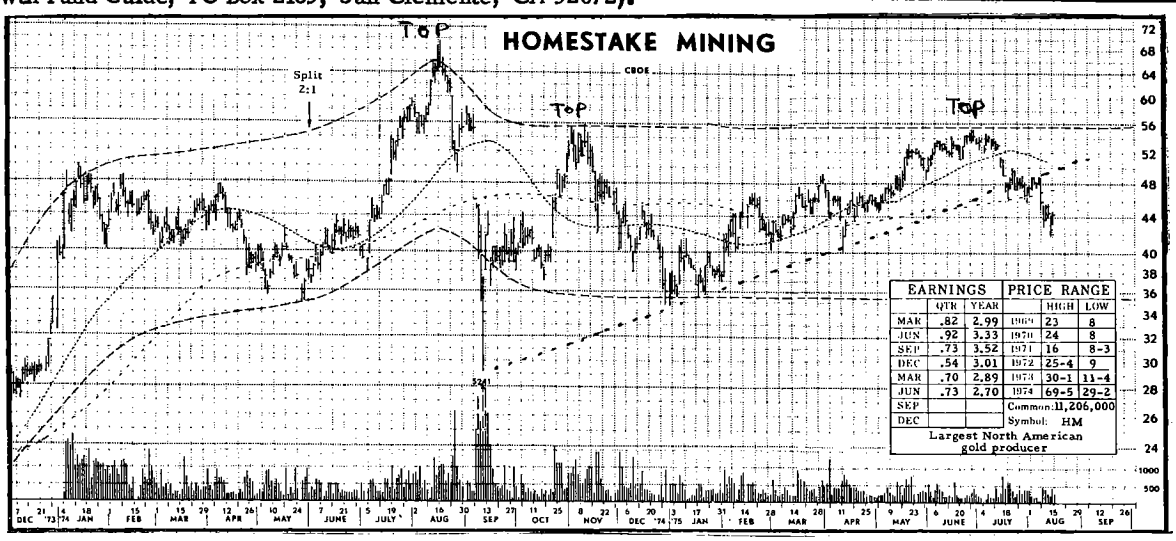
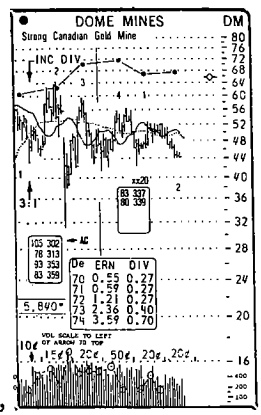
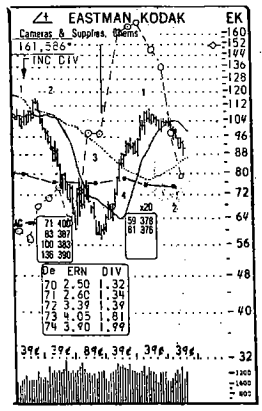


The daily chart of Homestake (page 6) presents a picture that I never like to see. The picture is of successive tops, each representing renewed distribution. I have labeled the three tops which have formed since 1974, and with the completion of the latest, HM should be ready to test or break the 1974 lows. The major trendline which has held since the 1974 low is now broken. So I personally won't argue with the HM picture, I'll just print the chart and let you see what I see. (Chart courtesy of Trend Guide, Box 35, Jacksonville Beach FL 32250.)



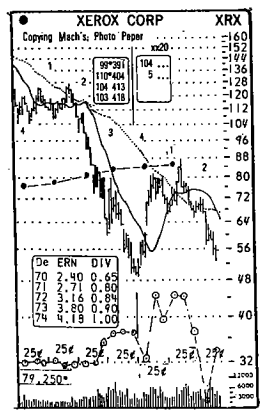


LATE NOTES: I've been flooded with letters, and I can't possibly answer them all. It isn't that I can't take the time. It's that each letter takes thinking and work, and I just have one brain, and it's not that great a brain at that. Therefore, if I really answer ten letters a day, really try to answer them, then I'm half used up for Dow Theory Letters, and I don't want to do that. My favorite letters (the ones I like to get most) are typed so I can read them, and they have a little note on the end saying, "This letter needs no reply."

In case you didn't notice it, this report is in seven pages instead of the usual six. Why? I had a lot to say, and I didn't feel like throwing some of it out this time.

* * * * * *

The market has been rallying on low volume, which is OK, but I feel that the rally is probably not going to be the real McCoy. What I do think is that any action on the Dow in the 790-830 range will simply build up a "right shoulder" on the "head-and-shoulders" top which has now formed. I include this chart of the Dow from Chartcraft, Larchmont, NY, and here you see what has happened from the standpoint of point & figure. We've got a big top here with a good chance of testing the basic bull trendline which began at the 1974 low (arrow). If that happens, the Dow could easily test into the low 700's, which is a possibility I have discussed all along. As some great philosopher once said, "Life is a struggle." And you can bet your last dollar that the market is part of life.



This is one of those rare instances when a good many diverse segments of the stock market are coming down together. Charts courtesy of Quote, PO Box 213, Wichita KS 67201.

Second Thought: A few subscribers comment that my adage about watching the guys who have been right and the ones who have been wrong on a contrary opinion basis is a good one. But then they ask, "Russell, how long can we believe you?" I want to say here and now that I never suggested that anyone believe me — and anyone who does is a fool. Read what I say, try to comprehend it, swish it around in your head. And then make up your own mind. I'm only human, and I'm going to be wrong somewhere ahead. I've done it before, and I can do it again.

LATE NONSENSE: I spent a few days up there in San Francisco and in Sausalito. Sausalito is a beautiful little town, but (and this is more than I can take) it has no beaches. You just keep walking and shopping. I like to waste time. I have to have a beach on which to lie down and waste time on. No beach, and Richard Russell can't survive. I tried it for 35 years in NYC, and I left for California more dead than alive. Some of my best thoughts arrive while I'm wasting time. I'll admit it here and now for the first time, I don't waste at least three hours a day I'm useless, and in that state I could never write this report.